No. 545

FEB 10 1951
CHARLES ELMORE CROPLEY
CLERK

Supreme Court of the United States

October Term, 1950

CHARLES E. SMITH AND SONS COMPANY,
HALL C. SMITH, TRANSFEREE,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI

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May it Please the Court:

Petition of Charles E. Smith and Sons Company, a corporation, under the laws of the State of Ohio and Hall C. Smith, as Transferee, said causes having been consolidated in the lower court, respectfully shows to this Honorable Court.

A.

SUMMARY STATEMENT OF THE MATTER INVOLVED

The corporate petitioner for many years engaged in the business of manufacturing shirts. For the fiscal year July 31st, 1942, it took on war contracts for the manufacture of tow targets for the United States. The individual owned 100% of the corporate stock which he acquired for $30,000.00; and made up all the officers of the corporation. By resolution of the Board the individual taxpayer's salary for the fiscal year 1942 was fixed at $52,000.00, and for the fiscal year 1943 at 15% of all net sales, but no less than $52,000.00. During the fiscal year 1943 he drew $52,000.00 and after the end of the year, it was computed that 15% of net sales amounted to a total of $87,265.08, so the individual drew the additional $35,265.08.

On July 31st, 1943, the corporation was solvent, but the payment of $35,265.08 to the individual for the balance of his salary made between July 31st, 1943 and September 1st, 1943 (R. 15) made the corporation insolvent as of September 1st, 1943 to the extent of $34,367.39 (R. 336).

The Tax Court of the United States in its decision, affirmed by the Court of Appeals, held the individual taxpayer liable as transferee to the extent of $57,265.08, having held that this amount was in excess of reasonable compensation.

During the fiscal year 1942 the corporate taxpayer paid out $23,591.54; and during the fiscal year 1943 the amount of $17,277.70 to an insurance company for purchase of policies of insurance, providing for retirement and death benefits for its some fifty-five employees.

B.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

1. The decision of the Court of Appeals for the Sixth Circuit decided a Federal question of substance in a manner contrary to the decision of this court in the case of *Philip* v. *Commissioner,* 283 U. S. 589.

2. The decision of the Court of Appeals for the Sixth Circuit is in conflict with the decision in the case of *Scott* v. *Commissioner,* 117 Federal (2d), 36, and *Borall* v. *Commissioner,* 167 Federal (2d), 865.

3. The decision of the Court of Appeals for the Sixth Circuit is in conflict with the decision in the case of *Commissioner* v. *Lincoln Electric Company,* 162 Federal (2d), 379 and *Mayson Manufacturing Company* v. *Commissioner,* 178 Federal (2d), 115.

4. Unless a decision is made by this Honorable Court upon the state of facts existing in the present cause, a great confusion will arise in the administration of the Internal Revenue laws of the United States in view of the conflict between the decisions of the different circuits of the Court of Appeals, as well as the decisions of different members constituting the Sixth Circuit Court of Appeals, and the conflict of the decision herein with a prior decision of the United States Supreme Court.

WHEREFORE this petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the Court of Appeals for the Sixth Circuit commanding that court to certify and to send to this Court for its review and determination, on a day therein named, a full and complete transcript of the record and all proceedings in the cause numbered and entitled on its docket No. 10819 Charles E. Smith and Sons Company—Hall C. Smith, transferee v. Commissioner of Internal Revenue, and that the said decision of the Court of Appeals for the Sixth Circuit rendered by it, October 20th, 1950 and its order refusing an application for rehearing entered by it on November 21st, 1950, may be reviewed by this Honorable Court, and that this petitioner may have such other and further relief in the premises as to this Honorable Court may seem meet and just; and your petitioner will ever pray.

CHARLES E. SMITH AND SONS COMPANY,
HALL C. SMITH, TRANSFEREE,
Petitioners.

By: SOL GOODMAN,
Attorney for Petitioners.

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SUPREME COURT OF THE UNITED STATES
October Term, 1950

No. ———

CHARLES E. SMITH AND SONS COMPANY,
HALL C. SMITH, TRANSFEREE,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

I.

THE OPINIONS OF THE COURT BELOW

The opinion of the Court of Appeals for the Sixth Circuit was rendered October 20th, 1950, and a Petition for rehearing overruled November 21st, 1950, and is reported in 184 Federal (2d) 1011. The Opinion of the Tax Court of the United States was rendered on the 12th day of May, 1947 and is reported in 11 T. C. 174.

II.

JURISDICTION

1. The jurisdiction of this Court to entertain a petition for a writ of certiorari and the allowance thereof is pro-

vided for in Judicial Code, 1254, Title 28, U.S.C.A., as amended by the Act of June 25, 1948, 62 Statutes 928.

2. The date of the judgment of affirmance to be reviewed is October 20th, 1950, together with the overruling of the petition for rehearing on November 21st, 1950.

3. The ruling of the Court of Appeals for the Sixth Circuit is in conflict with several other decisions of the Court of Appeals as shown under paragraph No. B. of the Petition and, is directly contrary to the decision of this Court in the case *Philip* v. *Commissioner,* 283 U. S. 589.

4. The jurisdiction of the Court is sustained by rule 38 Section 5 (b).

III.

STATEMENT OF THE CASE

A summary statement of the matters involved is set forth under paragraph A. in the Petition. From those facts, the following questions arise:

1. Where the individual petitioner was paid compensation in installments during the fiscal year ending July 31st, 1943, a total of $52,000.00 being paid during the twelve (12) month period, August 1st, 1942 to July 31st, 1943 and, an additional $35,265.08 being paid from August 1st to September 1st, 1943, and at the beginning of the year, the corporate petitioner was solvent and continued to be solvent during the entire year and at the end of the year having paid the fixed part of the salary ($52,000.00) its assets still exceeded liabilities by $877.69; by reason of the payment of additional salary of $35,265.08 during the first month of the next fiscal year it made the corporate liabilities exceed its assets by $34,387.39. May the individual petitioner be held as transferee, or at any event may he be held as transferee for mor than $34,387.39?

2. Where Petitioner, Hall C. Smith, had a salary of $87,265.08 fixed by the corporation for the fiscal year 1943 and through withholding tax, prepayment tax and income tax, he paid thereon the amount of $59,488.25, leaving him for his own use $27,776.83, can he be held liable as transferee in the amount of $57,265.08 because it is later determined that said salary was excessive and instead of $87,265.08 should have been only $30,000.00? Thus can petitioner, Hall C. Smith, be held liable for $116,753.33 ($57,265.08 transferee liability and $59,488.25 income tax paid) upon a total fixed salary of $87,265.08?

3. Petitioners paid $23,519.54 for the fiscal year 1942, and $17,277.70 for the fiscal year 1943, to a pension trust for its employees. The pension trust agreement provided pensions upon retirement for employees in form of annuity payments and death benefits of participants. The trust covered some 40 persons, constituting all the employees. Do such contributions constitute allowable deductions from gross income either as *contributions to a pension fund* or as *ordinary and necessary expenses* under the provisions of Section 23 (a) and 23 (p), I. R. C.?

4. An individual who owns all of the stock of a corporation makes an agreement with it that his salary is to be equivalent to 15 per cent of its net sales, is such an agreement binding for income tax purposes?

IV.

SPECIFICATION OF ERRORS

1. The Court of Appeals for the Sixth Circuit erred in affirming the decision of the Tax Court. In holding that the Tax Court had resolved a conflict in testimony against petitioner, it was not giving due consideration to the record.

There was no conflict in testimony. The evidence was undisputed and the decision was therefore wrong.

2. The Court of Appeals for the Sixth Circuit erred in finding that the individual petitioner was liable as transferee because the undisputed evidence showed that the corporation was solvent throughout the year.

3. The Court of Appeals for the Sixth Circuit erred in finding that the contributions to the pension fund were not deductible.

4. The Court of Appeals for the Sixth Circuit erred in finding that the officers' salaries were not deductible.

ARGUMENT

I.

On Ooctober 20, 1950, the Court of Appeals affirmed the Tax Court of the United States in the herein consolidated cause. In the opinion released that day, the Court held that questions of fact were involved which had been determined by the Tax Court and were being affirmed.

The Court said:

> "We do not discuss at length the item of transferee liability. The Tax Court found that the Commissioner did not sustain the burden of establishing liability for the year ending July 31, 1942, but assessed transferee liability for the subsequent year upon the ground that the payment of the salary of $87,265.08 to Smith for that year rendered the corporation insolvent.
>
> "The finding was based upon computations and adjustments in the corporation balance sheet, in which the Tax Court handled the petitioners' contention with liberality. Petitioners urged that the

> real estate was undervalued in the balance sheet, and the Tax Court adjusted the figure from $85,463.85, the cost in 1942, to $102,000, the price that the land brought at a sheriff's sale in 1945. All that appears upon this point is a conflict in the testimony resolved against the petitioner by the Tax Court, whose decision upon this question of fact, under familiar rules, we are bound to follow."

The Tax Court stated (R. 342) "the question of whether as a result of the distribution to Smith of $57,265.08 the corporation became insolvent during the fiscal year ending July 31, 1943. If it did, Smith is liable as transferee. If it did not, he is not liable."

The Tax Court cited, in support of its decision, the case of *Scott* v. *Commissioner,* 117 F. 2d 36. That decision, at page 39, held:

> "The distribution here was not parcelled out in installments but in its entirety and resulted in immediate insolvency. Perhaps, as argued by petitioners, some substantial amount of the distribution might have been made without rendering the corporation insolvent. A short answer to this contention is that the distribution was not so made."

In the present case, the Tax Court specifically found (R. 315) "the corporation paid Smith a salary of $87,265.08 for his services during the fiscal year ended July 31, 1943. All of this salary was paid during the period beginning August 1, 1942 and ended September 1, 1943." The Tax Court further found that at the beginning of August 1, 1942 the corporation had assets exceeding liabilities and taxes in the total amount of $25,000.00 (R.

334), and that as of July 31, 1943 it had liabilities exceeding its assets (R. 336) by $34,367.39. Having in mind that a portion of the excessive salary was found by the Court to have been paid as late as September 1, 1943; on July 31, 1943 some $35,265.08 remained unpaid, which left the corporation solvent at that time. At all events, *Smith's salary having been parcelled out in installments and not paid in its entiretly, the finding of transferee liability in any amount exceeding the total of its insolvency was definitely contrary to law.*

The Court's opinion refers to the fact that the Tax Court "handled the petitioners' contention with liberality". If the Tax Court finally held the petitioners liable as transferee for $57,265.08 as against its insolvency of $34,367.39, or for an amount exceeding its insolvency by some $23,000.00, the liberality of the Tax Court in valuing the petitioners' realty by some $16,000.00 more than its book value was of no benefit to the petitioners.

The Court stated in its decision that it would not discuss at length the item of transferee liability. It is petitioners' contention that if this item of transferee liability were examined the court would conclude that the decision of the Tax Court is contrary to the case of *Scott* v. *Commissioner,* 117 F. 2d. 36. There is direct conflict with the decision of the United States Supreme Court in the case of *Phillips* v. *Commissioner,* 283 U. S. 589, where at page 604, the Court stated as follows:

> "* * * The argument is that there may have been several distributions within this period; that since there was no finding as to the existence of other creditors, it must be assumed that until the assets had been depleted below the amount due for taxes, the corporation was solvent; and that thus the stockholder transferees did not become liable

until the final $9,306.36 of assets was distributed. * * * But the plain import of the findings is that there was a single distribution which took several months to complete; and there is no question that the entire assets were thereby distributed. Moreover, such argument, urged for the first time here, comes too late. For while the burden was on the Commissioner to prove before the Board that Phillips was liable as a transferee, the facts in the case at bar were stipulated; and it was agreed that the date of complete liquidation was September 27, 1919, by which time petitioners' decedent had received his full share of the distributed assets. Since it was stipulated that the final transfers of assets were without consideration; that they completely exhausted the corporate assets; that the balance of the deficiencies, assessed against the corporation, remains unpaid; and that the distributive dividend received by Phillips was in excess of the remaining tax liability, the burden resting upon the Commissioner was sustained.

Affirmed."

This case is unlike the decision in *Borall* v. *Commissioner*, 167 F. 2d, page 865, which involved a plan for liquidation. This is a case of *payments of salary made in installments* during a period of some thirteen months, and it appears over $35,000.00 of it paid after July 31, 1943 and by September 1, 1943 (the burden of establishing when insolvency occurred was on the Commissioner and not the petitioners). *Certainly any installment payments which were made at a time when the corporation is solvent are not payments in fraud of creditors and do not give the government, as a creditor, the right to assert transferee liability.*

II.

The Court, in its decision, sustained the disallowance of deductions for payments into the pension fund and based its decision on the ground that no finding was made that these paymets constituted reasonable compensation. The record in this case, at pages 37 and 39, indicates that the petitioners had some 40 employees included in the pension fund and on whose behalf the corporation paid out premiums in the amounts as shown in the stipulation of facts. In the fiscal year 1942, against a salary of $25,000.00 paid to all employees other than Hall C. Smith, the expenditure for the purchase of insurance for all employees except Hall C. Smith amounted to some $13,000.00. For the fiscal year 1943, as against a salary paid to employees other than Smith amounting to $42,000.00, there was paid for the purchase of insurance on all employees other than Smith some $12,000.00. The only possible construction of these agreed facts is that the purchase of insurance in the first year represented a payment for a period of time other than just that year when that is compared to the premium in the next year. *But notwithstanding that, the admitted facts indicate that this money was paid out for the employees and was a necessary expense which the corporation taxpayer incurred in the carrying on of its business.*

It has never been required that in a case of this sort that the petitioner proceed to offer evidence as to whether or not the janitor, machine operator, foreman or night watchman is overpaid or underpaid when his salary falls in the range of $35 to $75 per week. Simple arithmetic, when applied to the stipulation of facts (R. 39), indicates that except for Smith all other employees worked within that range, and as to the type of work that was done by them, it is certainly indicated by the testimony of the four or five employees who did testify.

The rule of evidence to be applied in such a case is the rule as stated in *Mayson Manufacturing Co.* v. *Commissioner*, 178 F. 2d. 115, that if compensation received was unreasonable for services rendered, the government could have produced some experienced witness who would have said so, and the lack of such evidence operates strongly against the Commissioner's contention that salaries paid were unreasonable.

An examination of the decision in the case of *Commissioner* v. *Lincoln Electric Company*, 176 F. 2d. 815, (wherein the same Court held that payments of premiums for insurance or contributions to a pension or trust fund are allowable deductions as "ordinary and necessary expenses" in carrying on a trade or business) indicates no evidence was offered as to each employee who was included in that fund and as to whether or not his salary was reasonable. (*See Lincoln Electric Co.* v. *Commissioner*, 162 F. 2d. 379).

In the latest decision in the case above quoted, Allen, Circuit Judge, dissented from the holding that the law required evidence to be offered on the question of reasonableness when applied to deductions of "ordinary and necessary expenses". Certainly this Court would be justified in reversing this case so that the Tax Court could consider the question of deductibility of these payments as "ordinary and necessary expenses", if not as to all employees, then certainly as to all employees other than Smith.

III.

The Court, in its opinion, found no basis for disturbing the holding that the salary of Hall C. Smith, as set up on the corporate books and minutes, was unreasonable. The Court did not pass on petitioners' contention that if Smith could

elect to operate as a corporation he could elect to operate part of the business as a corporation and part of it individually. *See Twin Oaks Co.* v. *Commissioner*, 183 F. 2d. 385.

If Smith had deducted only the amounts for salary found reasonable by the Court rather than the larger amounts, the amount of tax paid by Smith, together with the amount of tax which the corporation would have been required to pay would have been less than the total tax now proposed by the Commissioner, (See R. 10, 11, 12 and 13 for figures used in example), to the extent of the transferee liability of $57,265.08.

EXAMPLE

Corporation

Reported Income	$37,000.00	Paid by Corporation	$26,500.00
Excessive Salary	57,000.00	Indiv. Overpaid	48,500.00
Income	$94,000.00		$75,000.00
Tax 80%	75,000.00		

Individual

Income	$30,000.00
Income Tax	11,000.00
Paid	59,488.25
Overpaid	$48,500.00

CONCLUSION

This case presents a question of an individual, by reason of having received a salary of $87,000.00, of which $57,000.00 was held to be excessive, being, therefore, required to pay $57,000.00 as transferee liability after he has paid $60,000.00 as income tax. Thus, this decision affirms a holding that upon receiving the salary of $87,000.00, Smith became obligated to the Commissioner for a total of $117,000.00.

The Sixteenth Amendment to the United States Constitution gave Congress power to levy and collect taxes on *income*. In considering that Amendement, in the case of *United States* v. *Safety Car Heating and Lighting Co.*, 297 U. S., 88, the Court stated that "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition. * * * it is 'income' as the word is known in the common speech of men".

Under such provision of the Constitution and such decision of the United States Supreme Court, the holding of the Court sustaining the collection of a tax which amounts to nearly 140% of the "income" is entirely out of line with the principles of fairness, equity, law and justice.

Respectfully submitted,

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